Reading Essentials and Study Guide

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Chapter 12: Evaluating the Economy

Lesson 3 Poverty and the Distribution of Income

ESSENTIAL QUESTION

How do we determine the economic and social well-being of the United States?

Reading HELPDESK

Academic Vocabulary

impact effect

stagnant not changing

uniform even or consistent

Content Vocabulary

poverty threshold annual dollar income used to determine poverty

poverty guidelines administrative guidelines used to determine eligibility for certain federal programs

Lorenz curve graph showing how much the actual distribution of income differs from an equal distribution among the five quintiles

welfare government or private agency programs that provide general economic and social assistance to needy individuals

food stamps government-issued coupons that can be exchanged for food

Medicaid joint federal-state medical insurance for low-income people

Earned Income Tax Credit (EITC) federal tax credits and cash payments for low-income workers

enterprise zones areas free of local, state, and federal tax laws as well as other operating restrictions

workfare program requiring welfare recipients to work in exchange for benefits

negative income tax tax system that would make cash payments in the form of tax refunds to individuals when their income falls below certain levels

NAME ______________________ DATE ____________ CLASS ________

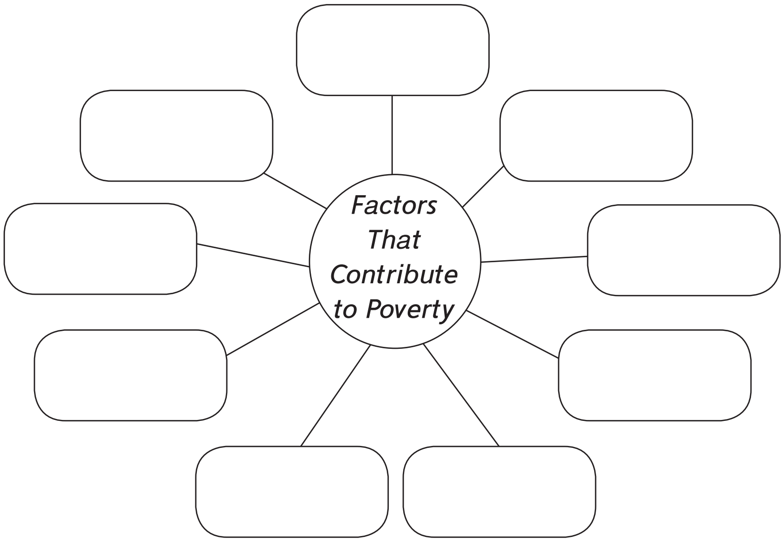
Reading Essentials and Study Guide

Chapter 12: Evaluating the Economy

Lesson 3 Poverty and the Distribution of Income, *Continued*

TAKING NOTES:
Key Ideas and Details

As you read, complete a graphic organizer like this one to keep track of the factors contributing to poverty in the United States.



Poverty

Guiding Question *How is poverty defined?*

Poverty is one of the hardest problems we have in our economy. We can define poverty, and we can explain some of the main reasons for it. But solving it has been a challenge since the mid-1900s. Poverty is relative, which means that poverty for one person may seem like riches to another person. It depends on prices, the standard of living, and the incomes that others earn. Let's look at how we define poverty in the United States.

Defining Poverty

*Economists classify people as living in poverty if their incomes fall below a certain level, or threshold. The **poverty threshold** is the benchmark we use to evaluate people's income. If they have incomes below the threshold, they are considered to be in poverty even if they have supplements such as food stamps, subsidized housing, and Medicaid.*

The Social Security Administration developed the thresholds in 1964 using two studies done by the U.S. Department of Agriculture in the 1950s. Its first study developed four healthy food plans for individuals and families of different sizes. It used the least expensive food plan as the food budget that would keep people out of poverty.

The second study found that families typically spend one-third of their total income on food. So the Social Security Administration multiplied the least expensive food budget by three to set the poverty threshold. It increases the thresholds every year to account for inflation.

The government simplifies the poverty thresholds to make **poverty guidelines**, or administrative guides. These guides determine who is eligible for certain federal programs such as the food stamps program and the Head Start program. **Figure 12.5** shows the guidelines for a recent year.

Historical Poverty Trends

*The most recent official poverty rate for the population of the United States was 15.0 percent, which is about 46,496,000 people. You can see this in **Figure 12.6**. The poverty rate has not changed in the past several years, even with the four years of modest economic growth since the Great Recession.*

The poverty rate for children under the age of 18 was almost 22 percent for the most recent year. Also, the poverty rate for people aged 65 and older was almost 9 percent. Children are the most vulnerable of all groups in poverty.

Distribution of Income

Economists also track the differences in income levels among households. They rank the incomes of all households from highest to lowest. Then they divide them into quintiles, or fifths. They can then figure out the percentage of the nation's household income for each quintile.

The table in **Panel A** of **Figure 12.7** shows household income quintiles for three different years. The table only counts income received from working. It does not include other aid such as Medicaid, food stamps, or subsidized housing. If we add each quintile's percentage to the other percentages, we will see a Lorenz curve. The **Lorenz curve** shows the actual distribution of income and how it is different from an equal distribution of income. You can see the 2012 incomes plotted as a Lorenz curve in **Panel B**.

For example, Panel B of Figure 12.7 shows that 3.2 percent of total income that the lowest quintile earned in 2012. We add this amount to the 8.3 percent that the next quintile earned. We continue like this until we plot the cumulative amounts of all quintiles.

If all households received the same income, the Lorenz curve would be a straight diagonal line from one corner of the graph to the other. This would mean that 40 percent of the households earned 40 percent of the total income, for example. But all households do not receive the same income, so the Lorenz curve is not a diagonal line. As you can see in the figure, the distribution of income has become more unequal than it was in 1990.

We can also use a Lorenz curve for other groups besides households. There are Lorenz curves for individuals, families, and occupations.

Reading Progress Check

Describing How were poverty thresholds developed?

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Reasons for Income Inequality

Guiding Question *Which factors are most important in unequal income distribution and why?*

There are at least nine reasons why incomes vary. Education and wealth are two of the most important reasons.

Education

One of the biggest reasons for differences in income is education. People's income normally goes up as they get more education. In the last 30 years, the gap has widened between well-educated and poorly educated workers. This has caused wages for highly skilled workers to soar, while wages for the less skilled have remained about the same.

You saw proof of the importance of education back in Figure 1.8. This figure shows that someone with a college degree earns more than double what someone without a high school diploma earns, on average. Also, a person without a high school diploma will be jobless nearly three times more often than someone with a college degree.

The conclusion is that education pays. It is one of the best ways to avoid poverty.

Wealth

Income also varies because some people have more wealth than others. The distribution of wealth is even more unequal than the distribution of income. For example, people were ranked from highest to lowest wealth in 2007, the year before the Great Recession. The top one percent held 34.6 percent of all the wealth in the country. The bottom 80 percent of people in the country had about 15 percent of the total wealth. After the recession, the top one percent increased their share of wealth to 37.1 percent. The share of the bottom 80 of the population fell to 12.3 percent.

This inequality has a huge **impact** on people's ability to earn income. Wealthy families can send their children to expensive colleges and universities. The wealthy also can afford to set up their children in businesses where they can earn a better income. Even if the very wealthy choose not to work, they can make investments that will earn additional income.

Tax Law Changes

In recent years, Congress has changed many tax laws. The laws have reduced taxes for almost all Americans. But they have reduced taxes on high incomes more than on lower incomes, which has made incomes even more unequal.

The 15 percent tax rate for income that comes from corporate dividend payments (money paid to shareholders of stocks based on the company's profits), for example, is the same as the second-lowest tax rates for the poorest Americans. A wealthy person who has millions of dollars invested in the stock market may receive large amounts of income from dividends. These dividends are taxed at either 15 or 20 percent, based on the person's total income. Many people who earn far less in income pay 25 percent or more in income taxes. So someone with $8,000,000 of stock still pays the same tax rate on dividends as someone who only earns $20,000 a year.

Decline of Unions

As heavy manufacturing has declined in the United States, union membership has fallen, especially among less-skilled workers. This has added to the growing income gap because there is less opportunity for unions to negotiate for higher wages. High school graduates who once followed their parents into high-paying factory jobs cannot do this anymore. They have to find other work, often for much lower pay.

These workers are also less likely to get more education beyond high school. Without more education, they probably cannot replace their high-paying factory jobs with other high-paying jobs. This is another reason for unequal incomes.

More Service Jobs

The U.S. economy has also changed from producing goods to producing services. This has widened the income gap. Because wages in service industries are usually lower and more people are working in these kinds of jobs, annual incomes are lower. Examples of service industries include restaurants, movie theaters, and clothing stores.

Advances in Technology

Advances in technology mean that many service jobs do not require as many skills as before. For example, a cashier at a fast-food restaurant no longer needs to know how to accurately add up several separate purchases, or make change for a $10 bill. Instead, the register calculates the total and tells the cashier how much change to give the customer.

When a job requires fewer skills, the wages will be lower. Wages may even be **stagnant** over time.

Monopoly Power

Another reason for differences in income is the monopoly power of some groups. Unions have been able to get higher wages for their members in the past. Some white-collar organizations also have some monopoly power if they can affect the number of workers in their industry. White-collar workers include clerical, business, or professional workers who mostly are salaried.

For example, the American Medical Association may work to limit the number of people who can become doctors, which aids in the restriction of medical school certifications. This has been a major reason for the increase in income of doctors.

Discrimination

Discrimination also affects the distribution of income. For example, male business leaders may not promote women to higher-paid leadership positions because the men are not accustomed to women in roles of power. Some unions may deny membership to immigrants or ethnic minorities.

Workplace discrimination is illegal, but it still happens. When it does, it crowds women and minority groups into other labor markets where oversupply pushes wages down.

Changing Family Structure

A final reason for the growing income gap is related to the changing structure of the American family. Shifting from two-parent families to single-parent families usually decreases the average family income. All of these reasons add to the trend of the rich getting richer and the poor getting poorer.

Reading Progress Check

Synthesizing Which factors are most important in unequal income distribution? Why?

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Antipoverty Programs

Guiding Question *To what extent should the government financially support those in poverty?*

Over the years, the federal government has tried different programs to help those in need. Most of these are ***welfare*** *programs. Welfare is economic and social help from the government or private agencies to people in need.*

Reducing poverty has been difficult. Even the large economic expansions of the 1980s and 1990s failed to greatly lower the percentage of Americans living in poverty. You can see this in Figure 12.6. Some of the programs helped reduce the percentage of population living in poverty from the record-high levels in the early 1960s. But progress since then has been very difficult.

Income Assistance

Income assistance includes programs that provide direct cash assistance to those in need. One program is the Temporary Assistance for Needy Families (TANF), which began in 1997. Benefits are different from state to state, but many families qualify for small cash payments. These payments are because of the death, continuous absence, or permanent disability of a parent. More recently, Congress voted to tighten the rules and toughen work standards for two-parent households.

Another income assistance program is the Supplemental Security Income (SSI). SSI makes cash payments to blind or disabled people or to people ages 65 and older. Originally, the states managed the program. But the federal government took it over to provide more **uniform** coverage because benefits varied so much from state to state.

General Assistance

Programs that help poor people but do not give direct cash assistance are called general assistance programs.

- **Supplemental Nutrition Assistance Program (SNAP)**—SNAP is a program that serves millions of Americans. It is commonly known as "food stamps." The **food stamps** are government coupons that people can redeem for food. They may be given or sold to eligible low-income people. For example, if a person pays 40 cents for a $1 food stamp, that person can get a dollar's worth of food for a fraction of the cost. The program became law in 1964. It is different from other programs because eligibility is based only on income.
- **Medicaid**—Another general assistance program is **Medicaid**. This is a joint federal-state medical insurance program for low-income people. The federal government pays most of the health-care costs, and state governments cover the rest. Medicaid serves millions of Americans, including children, the visually impaired, and the disabled.

Social Service Programs

Over the years, individual states have developed social service programs to help the needy. These programs include child abuse prevention, foster care, family planning, job training, child welfare, and day care.

States control the kinds of services the programs provide, but the federal government may match part of the cost. To be eligible for matching funds, a state must file an annual service plan with the federal government. If the federal government approves the plan, the state can choose which social issues to address, set the eligibility requirements, and decide how the programs will run. As a result, the range of services and support may vary from state to state.

Tax Credits

Many working Americans qualify for special tax credits. The most popular is the ***Earned Income Tax Credit (EITC)****, which provides federal tax credits and even cash to low-income workers. The government created the credit to help ease the payroll tax burden on working families. The credit is applied first to federal income taxes. Low-income workers can take the rest of the credit in cash if the credit is more than what they owe in taxes.*

The EITC is a tax credit, but it was also meant to encourage people to get a job and go to work. You cannot file for the EITC unless you are working. The credit is popular, and millions of working families receive benefits annually.

Enterprise Zones

Special ***enterprise zones*** *are areas where companies are free of some local, state, and federal tax laws and other operating restrictions. Many enterprise zones are set up in run-down or depressed areas. This benefits the people who live in these areas because they can find work without worrying about transportation.*

Most people agree that a healthy and growing economy helps lessen poverty. The goal of the enterprise zone is to encourage growth directly in the areas that need it most by making more employment opportunities available.

Workfare Programs

Many state and local governments require people who get welfare to provide labor in exchange for benefits. This is because of rising welfare costs. For example, in the ***workfare*** *program, people who receive welfare work for their benefits. People on workfare often help law enforcement officials or sanitation and highway crews. They might also work in schools or hospitals, or do other types of community service work.*

Most states with workfare programs require almost everyone to work except for the disabled, the elderly, and those with very young children. If the workfare projects are well planned, then workers have a valuable opportunity to learn new skills that could help them get other jobs.

Many welfare-to-work programs have had encouraging results. In some cases, companies can even earn federal tax credits when they hire workers directly from the welfare rolls. This type of employment is a win-win situation for employer and employee because both benefit.

Exploring the Essential Question

Which statement best describes the goals of many anti-poverty programs?

1 To prevent the needy from having to work at low-paying jobs.
2 To provide financial assistance and help people find jobs to support themselves.
3 To encourage poor students to stay in school.

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Negative Income Tax

*The **negative income tax** is a type of tax that would give cash to certain groups of people whose incomes are below the poverty line. The program is not yet in use, but it is an attractive idea because the cash payments would take the place of existing welfare programs instead of adding to them. Also, everyone would qualify for the program, not just working people, as with the EITC.*

Under the negative income tax, the federal government would set an income level, and people below this level would not have to pay taxes. The government would pay a certain amount of money to anyone who earned less than that amount.

For example, suppose we calculate a person's tax liability with this formula:

taxes = (25% of income) – $8,000

With this formula, a person with no income would have a tax of minus $8,000. This means that the person would receive $8,000 from the government. If the person earned exactly $12,000, then the taxes would be $3,000 minus $8,000, so they would get $5,000. This means the person would get a total of $17,000 ($5,000 from the tax formula plus the $12,000 in earned income). A person would have to make $32,000 before he or she actually paid any taxes.

The negative income tax is different from other antipoverty programs in two ways. First, it is designed to encourage people to work. The goal is to make the minimum payment large enough to help, but small enough so that people are better off working. When people work, their taxes need to be low so they are not discouraged from working. Second, the negative income tax would save money because it would replace other, more costly, welfare programs. Plus the government would save on administrative costs.

An Extremely Difficult Problem

You might wonder about the result of all these programs since the mid-1970s. Sadly, poverty has been a very difficult problem to solve even during times of strong economic growth. Economic growth is important, of course, but it is not enough to reduce poverty.

There are strong reasons to try to reduce the problem of poverty. Millions of Americans would be better off, and everyone else in the economy would be better off, too. If many people cannot earn and spend, there will be fewer people to buy the products that our economy produces.

Reading Progress Check

Summarizing What are the benefits of the EITC to a working person?

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